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UNCLAS SECTION 01 OF 04 WELLINGTON 000342

SIPDIS

SENSITIVE

STATE FOR EB/TPP AND EAP/ANP
STATE PASS USTR-BWEISEL AND DKATZ
COMMERCE FOR ABENAISSA/4530/ITA/MAC/AP/OSAO

E.O. 12958: N/A
TAGS: ECON ETRD PREL NZ
SUBJECT: IN SEVERAL WAYS, LABOUR GOVERNMENT BETRAYS REFORMS THAT MADE NEW ZEALAND'S ECONOMY STRONG

REF: (A) 04 WELLINGTON 428; (B) 04 WELLINGTON 291

(U) Sensitive but unclassified -- please protect accordingly.

¶1. (SBU) Begin summary: Never entirely content with the market-opening reforms that New Zealand's Labour government spearheaded in the mid-1980s, the leaders of today's Labour government have rolled back several of those reforms. Over the last four years, the government has intervened in the energy market, restricted competition in the telecommunications sector, increased state ownership of business, and taken a "pick-winners" approach to economic development -- all actions contrary to the 1980s reforms that were based on the belief that unfettered competition would strengthen the economy. Labour's actions partly reflect its desire, especially in this election year, to reaffirm links with its traditional allies, particularly labor unions, and with average New Zealanders who feel they have been left behind by their country's recent robust economy. Ironically, the recent prosperity -- marked by strong growth and low unemployment -- was spawned largely by the dramatic structural reforms undertaken by the Labor government in the mid-1980s. In the short term, the turnaround in some government policies is unlikely to dampen the current economic expansion, which is expected to slow over the next year for other reasons. However, the changes could have long-term consequences and hamper the government's longstanding quest to return New Zealand to the top half of the OECD. End summary.

A late harvest
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¶2. (U) By the mid-1980s, New Zealand -- with one of the most regulated and protected economies in the OECD -- was saddled with rising inflation, unemployment, taxes and government spending. Its decade-old economic policies of smoothing out problems with government spending were unsustainable. The New Zealand currency's fixed exchange rate was under pressure, and its credit rating was sinking. Beginning in 1984, the Labour government dramatically transformed the economy, removing subsidies and most tariffs; floating the exchange rate; abolishing controls on interest rates, wages, prices and capital movement; and privatizing many state-owned enterprises. The reforms boosted competition in the private sector and placed New Zealand among the world's most open economies.

¶3. (U) Two decades later, the reforms undergird five years of economic expansion. New Zealand's economy has grown at or above the OECD average, with average annual GDP growth at nearly 4 percent since the last recession in 1998. In 2004, the economy grew 4.8 percent. The unemployment rate, at 3.6 percent, is the lowest in the developed world, and the government has a budget surplus equivalent to 4 percent of GDP. Inflation has remained within the central bank's target band of 1 to 3 percent.

¶4. (U) However, other factors signal the ride may soon be over. With a forecast fall in the terms of trade, declining net migration, slower consumer spending and the lagged effects of high interest rates and a high New Zealand dollar, economic growth is expected to slow in late 2005 or early 2006.

¶5. (SBU) While the current Labour government has left the 1980s reforms largely in place, it also has tinkered with the details. Motivated by a philosophical desire to protect domestic interests and to redistribute the country's wealth, the government has made policy decisions that have decreased competition in the marketplace. Those decisions complicate the government's goal of returning New Zealand to the top half of OECD countries in terms of GDP per capita.

Energy: Un-level playing field
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¶6. (SBU) The long-term security of New Zealand's energy supply remains uncertain, with its major gas field expected

to run out by 2007; limitations on its ability to expand its principal source of electricity, hydroelectricity; and its commitment to the Kyoto Protocol (ref A). The government has mapped for itself a larger role in securing New Zealand's energy future. When the industry failed to agree on rules for self-regulation, the government in September 2003 set up a regulator, the Electricity Commission, and charged it with ensuring security of supply and reserve generation. So far, the commission has appeared to be evenhanded in its oversight of industry, but its most difficult decisions lie ahead.

¶7. (SBU) In the meantime, the government has intervened in other ways to favor certain energy companies -- particularly, state-owned enterprises. State-owned Genesis Energy announced in August that it would proceed with plans for a new gas-fired power station after the government agreed to share the risks if it were unable to obtain sufficient gas supplies.

¶8. (SBU) Private companies complained that they had not been allowed to compete for similar government assistance. Roy Hemmingway, the Electricity Commission's chair, said that favoring a state-owned company over private competitors would distort the market and risk driving new private investment out of the sector. "Investors are keen to know the government will not intervene on the side of the state-owned enterprises, and the government has not provided that assurance," he said. Three state-owned enterprises supply about 60 percent of the country's generation capacity; three private companies provide about 40 percent.

Telecom: A local company favored

¶9. (SBU) In May 2004, the government announced that it would not order Telecom Corp., the country's former state monopoly, to open its fixed-line telephone service to competition (ref A). The decision was politically motivated and contrary to the advice of Ministry of Economic Development studies that showed economic benefits would result from unbundling the local loop. Official papers also revealed that the decision, based on a regulatory board's recommendations against unbundling, had been opposed initially by Minister of Communications Swain. But, the Cabinet overruled him, and Swain announced the decision to accept the board's recommendations.

¶10. (SBU) TelstraClear, a subsidiary of Telstra Corp. of Australia, is Telecom's land-line rival and would have been the primary beneficiary of a decision to unbundle the local loop. As an official from the Ministry of Foreign Affairs and Trade said, "You didn't expect this government to favor an Australian company at the expense of (New Zealand's) Telecom?" The government's go-slow approach to deregulating the sector thus has abetted Telecom.

¶11. (SBU) Greater competition in the marketplace was expected to spur lower prices for telephone services and increase broadband access in the country, which is among the lowest in the OECD at 2.7 percent of households. Prices for mobile, residential and business telephone services in New Zealand are significantly higher than the average for other OECD countries. Following the decision to not unbundle, several companies, including TelstraClear, announced they would reduce their investment plans in New Zealand.

Banking: Creating a state-owned rival

¶12. (U) With the acquisition of New Zealand's major banks by larger Australian institutions, the Labour government proved amenable to the desire of its coalition partner to create a locally owned bank. In 2002, the government bankrolled NZ $78.2 million (US $56.6 million) to establish a new retail bank called Kiwibank that operates out of the state-owned postal outlets. Since then, the government has added NZ $40 million (US $29 million) to support the bank's capital base.

¶13. (SBU) The bank, which holds less than 1 percent of the country's banking assets, contributes little to economic growth. It competes largely with other small banks and offers no services not already provided by its rivals. It did report its first profitable period (unaudited), for the six months to December 31. But Kiwibank's long-term viability remains untested. For example, it does not yet provide business services, which would require another infusion of government cash. The top four of New Zealand's 16 registered banks are owned by Australian institutions and account for about 85 percent of banking industry assets.

Picking winners: The government bets

¶14. (U) As part of a concerted economic-growth strategy and to wean New Zealand from dependence on agricultural

exports, the Prime Minister in February 2002 announced a plan to focus government assistance on three particular sectors: biotechnology, information and communications technology, and the creative industries, including film production. With this program, the Prime Minister signaled the end of what she called "hands off" economic management and the start of "smart interventions to facilitate economic growth." The government contended that it was compensating for a market failure by providing investment in areas where private financing was unavailable or scarce.

¶15. (U) The program, called the Growth and Innovation Framework, provides grants for such initiatives as education, industry training, research and investor promotion in each of the three sectors. A system of subsidies for large-budget film and television productions was added in July 2003. For both local and overseas projects that meet certain criteria, the government covers 12.5 percent of a project's New Zealand-based production costs. Essentially, this amounts to a refund of the goods and services tax.

¶16. (SBU) This "picking winners" scheme is criticized by a number of New Zealand economists, who argue that such government assistance constrains the workings of an open and competitive market. In an economic survey, the OECD said the film production subsidies set "an unhelpful precedent." It added, "Setting an uneven playing field may not only misallocate resources but would also create incentives for wasteful rent-seeking."

¶17. (SBU) New Zealand's auditor-general in December raised concerns over how the government has administered the Growth and Innovation Framework. The auditor-general noted that basic information for some grants was not available, criteria were not adequately considered when decisions were made and little effort was undertaken to analyze the risks of the government's investment. The auditor-general's conclusions demonstrate that governments may not be best equipped to decide which sectors would best deliver growth for their economies.

Labor: Currying favor
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¶18. (SBU) Current government leaders do share some goals with their predecessors of two decades ago, particularly a desire to protect labor. Through legislation enacted in 2000 and 2004, the current government has restored many benefits to organized labor that were stripped away by the National government in 1991. It has given workers the right to strike in pursuit of multi-employer contracts, required that parties bargain in good faith in a labor dispute and provided protective measures for workers in the event of ownership changes. It also has increased workers' annual leave and holidays. Critics contend that these measures have raised the cost of doing business in New Zealand, will deter investment and will inhibit growth.

¶19. (SBU) Labor's bargaining power also has been strengthened by a surge in public sector employment -- a 14 percent rise in the last five years -- that has crowded out private hiring in a tight labor market.

Comment: A reputation frayed?
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¶20. (SBU) The government's spirited interventions in the economy arise from a political desire to cement the support of its bread-and-butter constituency -- unions and the working class. The interventions also reflect a philosophical belief in redistributing the country's wealth in a quest to create a fairer society. We do not know whether Labour will continue in this direction if it wins, as expected, a third term in office in this year's elections, although if it governs in coalition with the Green Party (a strong possibility), an interventionist bias is likely. One economist noted that, despite its interventions, the government overall has maintained responsible fiscal and monetary policies that have controlled government spending, put the operating budget in surplus and decreased net government indebtedness, while holding inflation in a low targeted range.

¶21. (SBU) Meanwhile, the government's interventions will likely contribute little to its goal of boosting New Zealand's long-term growth. Certainly, the interventions run counter to New Zealand's reputation for its cutting-edge liberalizing economic reforms. They also do not create a conducive environment for business to expand, create new jobs and improve labor productivity, which New Zealand's central bank and local economists say is key to expanding the economy.

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